SENATE RECORD VOTE ANALYSIS

PRIVATE SECURITIES LITIGATION/Joint Liability

SUBJECT: **Private Securities Litigation Reform Act of 1995 . . . S. 240. Shelby/Bryan amendment No. 1468.**

ACTION: AMENDMENT REJECTED, 30-56

SYNOPSIS: As reported with an amendment in the nature of a substitute, S. 240, the Private Securities Litigation Reform Act, will enact changes to current private securities litigation practices in order to discourage unjust suits and to provide better information and protection from fraud for investors.

The Shelby/Bryan amendment would amend the liability section for securities fraud. Under current securities law, a defendant who is found guilty of intentional or knowing fraud, or of reckless conduct related to such fraud, may be held jointly and severally liable. Securities actions are typically brought under the catchall fraud provision contained in Section 10(b) of the Securities Exchange Act and the Securities and Exchange Commission (SEC) Rule 10b-5. Congress never expressly provided for private rights of action when it enacted Section 10(b). The standards for finding recklessness, as a result, vary from court to court and case to case. All defendants in a securities litigation case are jointly and severally liable, meaning that if the amount that one defendant is liable for is not recoverable from that defendant, then it may be recovered from other defendants. Thus, if a defendant who is found to be 1 percent responsible for securities fraud is the only defendant from whom recovery is possible, that defendant may be ordered to pay 100 percent of the award. The bill substitute will change current law by limiting joint liability for defendants who are found to be culpable due to recklessness. Such defendants will retain joint and several liability for awards to plaintiffs who have net worths of less than $200,000 and who have lost more than 10 percent of their net worths, but for awards to other plaintiffs their joint liability will only apply to the extent that recovery is not possible from those guilty of knowingly committing fraud, and will be limited to no more than 50 percent of their proportionate liability. The Shelby/Bryan amendment would instead provide that defendants found guilty of reckless conduct, to the extent that a judgment were not collectible from the defendant or defendants found guilty of knowing securities fraud, would be responsible for paying that judgment in proportion to their percentage of responsibility.

Those favoring the amendment contended:

(See other side)

YEAS (30)		NAYS (56)			NOT VOTING (13)	
Republicans (5 or 11%)	**Democrats (25 or 61%)**	**Republicans (40 or 89%)**		**Democrats (16 or 39%)**	**Republicans (8)**	**Democrats (5)**
Cohen	Akaka	Abraham	Hatch	Baucus	Campbell-2	Bumpers-2
Jeffords	Biden	Ashcroft	Hatfield	Bingaman	Gramm-2	Harkin-2
Shelby	Boxer	Bennett	Helms	Byrd	Kempthorne-2	Moynihan-2
Snowe	Bradley	Brown	Hutchison	Conrad	Kyl-2	Pryor-2
Thompson	Breaux	Burns	Inhofe	Dodd	McCain-2	Simon-2
	Bryan	Chafee	Kassebaum	Ford	Simpson-2AN	
	Daschle	Coats	Lott	Glenn	Specter-2	
	Dorgan	Cochran	Lugar	Johnston	Thomas-2	
	Exon	Coverdell	Mack	Lieberman		
	Feingold	Craig	McConnell	Mikulski		
	Feinstein	D'Amato	Murkowski	Moseley-Braun		
	Graham	DeWine	Nickles	Murray	**VOTING PRESENT(1)**	
	Heflin	Dole	Packwood	Nunn	Bond	
	Hollings	Domenici	Pressler	Pell		
	Inouye	Faircloth	Roth	Reid		
	Kennedy	Frist	Santorum	Robb		
	Kerrey	Gorton	Smith			
	Kerry	Grams	Stevens			
	Kohl	Grassley	Thurmond			
	Lautenberg	Gregg	Warner			
	Leahy					
	Levin					
	Rockefeller					
	Sarbanes					
	Wellstone					

EXPLANATION OF ABSENCE:
1—Official Buisiness
2—Necessarily Absent
3—Illness
4—Other

SYMBOLS:
AY—Announced Yea
AN—Announced Nay
PY—Paired Yea
PN—Paired Nay

Compiled and written by the staff of the Republican Policy Committee—Don Nickles, Chairman

The Shelby amendment provides a fairer reform of joint and several liability in securities actions than does the bill substitute. The simplest way to understand the current law, the bill substitute proposal, and the Shelby proposal is with an example. Assume that an investor is defrauded of $1 million, that 90 percent of the liability is assigned to a primary defendant who deliberately engaged in the fraud, that 5 percent of the liability is assigned to another primary defendant who deliberately engaged in the fraud, that 4 percent of the liability is assigned to an accounting firm that recklessly failed to detect the fraud, and that the remaining 1 percent is assigned to another accounting firm that recklessly failed to detect the fraud. Under current law, each of these defendants is jointly and severally liable for the entire $1 million. Thus, if the $900,000 that is due from the defendant who was 90 percent responsible cannot be collected from that defendant, then the other defendants must pay it.

The sponsors of the substitute do not believe that it is fair to make defendants who are guilty of recklessness jointly and severally liable. Accordingly, they have proposed that such defendants will only pay more than their proportionate liability if that excess is uncollectible from defendants who are guilty of knowing fraud. In such a case, they will have full joint liability for paying plaintiffs with net incomes under $200,000 and who have lost at least 10 percent of their net worth. For other defendants, the amount of additional liability will not exceed more than 50 percent of their proportionate liability. Thus, if in the above example the defendant with 90 percent of the liability could not pay, then the primary defendant with 5 percent of the liability would assume that liability. If that defendant could not pay, then the two other defendants would together pay an additional $25,000 (50 percent of their 5 percent of $1 million, or $50,000, liability). The plaintiff, who suffered a $1 million loss, would recover only $75,000.

Under the Shelby amendment, joint liability would only apply to defendants guilty of recklessness after it had been applied to those guilty of knowing fraud, and it would be applied proportionately. Thus, in the above example, if no money was collectible from the primary defendant with 90 percent liability, and 50 percent was collectible from the primary defendant guilty of 5 percent liability, that 50 percent would be collected. For the remaining 50 percent, $400,000 would be due from the accounting firm with 4 percent liability, and $100,000 would be due from the accounting firm with 1 percent liability. The victim would recover the full $1 million.

The reason that our colleagues proposed the bill substitute changes is that they do not believe that defendants guilty of reckless conduct should be treated as harshly as defendants who are guilty of knowingly committing fraud. We agree, but we think our colleagues' proposal goes way too far, because it will also put the interests of parties that are guilty of reckless conduct ahead of the interests of those people who have been hurt by that conduct. The standard commonly used by the courts for reckless conduct in a securities case is "A highly unreasonable omission involving not merely simple or even gross negligence but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant, or is so obvious that the actor must have been aware of it." This standard is pretty strict. If a company's conduct is so egregious that it is worse than gross negligence, that company should not be limited to paying just a little more than its proportionate share of its liability if the result is that an innocent victim of fraud will not be able to make a full recovery. A plaintiff who has been defrauded out of $1 million and can only collect from a single defendant whose reckless conduct was responsible for 10 percent of that loss should not be limited to collecting just 10 percent. It is far more just to make a guilty party pay more than its fair share of the blame than to leave an innocent victim partially uncompensated.

The Shelby amendment, like the bill substitute, would require that joint liability be applied to knowing defendants first. However, any joint liability that could not be paid by knowing defendants would be paid according to the proportionate liability of the reckless defendants. This amendment would thus limit the liability of reckless defendants, but at the same time would protect the right of innocent plaintiffs to full recovery. We urge our colleagues to vote in favor of this reasonable compromise amendment.

Those opposing the amendment contended:

Our colleagues' reasoning is faulty because it is based on two myths--that a "recklessness" standard exists and that it is fairly applied. We have not simply proposed limiting joint and several liability for defendants found guilty of recklessness because it is a lesser degree of culpability--we have proposed it because it is a vague and arbitrarily applied standard that is used in practice to blackmail legitimate businesses that are guilty of nothing more than having money available to be stolen.

Each year about 300 securities cases are brought, and approximately 93 percent are settled out of court. The lawyers who file those cases typically walk away with several million dollars, and the stockholders whom they supposedly represent are given a few cents per share. Those stockholders also get to see their company lose a few million dollars to lawyers for no reason, and they also get to see their dividends cut because of those suits. In almost all of these cases the companies that are settling out of court are not being accused of knowingly committing fraud. Instead, they are being charged with "recklessness" because they were minimally connected with a party charged with fraud. Anytime a company loses more than 10 percent of its value, it is likely that a law firm that specializes in securities suits will find a stockholder whom it will pay to represent in court in a class action suit alleging that the loss was due to fraud. Typically, those suits allege hundreds of millions of dollars in damages, and they will name the companies' auditors, lawyers, and investment advisers as co-defendants. Those co-defendants are named because they have money.

Companies that settle out of court do not do so because they are guilty. Instead, they do so because the cost of fighting a suit, however frivolous, is prohibitive, and because the capricious nature of the current system always leaves open the possibility that an unjust suit will succeed. Banks, accounting firms, and law offices, when named as secondary defendants in a several hundred million dollar suit, will almost always willingly settle out of court for a couple of million dollars. If they do not, the cost of discovery alone to fight a suit will exceed the cost of settling. If a company decides to fight a suit, it is taking a huge risk. Though it will have, on average, better than a 90 percent chance of winning, the cost of a loss may be a $300 million or $400 million judgment. Most companies would be bankrupted by such a judgment. Though it is hardly fair to the employees or stockholders of companies, the safest and most sensible way to escape from the securities suits of buccaneer barristers is to pay the equivalent of protection money.

Our colleagues have cited one scienter standard used for reckless conduct as though it were writ in stone. Unfortunately it is not. The recklessness standard, such as it is, has been developed by the courts and its application varies from jurisdiction to jurisdiction and case to case. The standard is basically whatever a particular court says it is. Compounding this problem, juries are not composed of legal scholars; they often make mistakes because they are not suited to weigh the distinctions between innocent mistakes, simple negligence, gross negligence, and recklessness.

To move this debate to a practical level, assume a company planned on bringing a new product to the market in August. Assume that of the hundreds of memos that crossed the Chief Executive Officer's (CEO's) desk on that product, a handful of the memos from one branch of the company may have set forth reasons why it thought the product would be delayed for a few months. If the CEO thought that the reasons offered by this one branch were not persuasive, and were refuted by arguments put forth by other branches within the company, he or she might still predict that the product would be introduced. If the minority opinion turned out to be accurate, lawyers could file suit alleging that their clients who invested in the company based on their belief that the product would be introduced were deliberately misled by the CEO, because he "knew" the minority opinion was true. Additionally, they might also sue an auditor of the company for recklessness, not because it knew about the minority opinion, but because it failed to find out about it. Legally, in this case, we are not even talking about simply negligence--the CEO was mistaken, and it is unreasonable to expect the auditor to have found the few memos in disagreement and to have agreed with those memos, against the judgment of everyone else in the company. Still, it is in this type of case that skillful lawyers have on a few occasions managed to have a small portion of blame assigned to companies on the margins of a suit. A jury, unversed in the legal distinctions between recklessness, negligence, and innocent mistakes, may decide to give an auditor 1 percent of the blame. If this auditor has hundreds of millions in assets, and none of the other defendants has any money, it will then have to pay 100 percent of the judgment.

The solution offered by the substitute amendment to this bill is to limit joint liability for defendants found guilty of recklessness. They will still have full liability for small investors, but for paying large, sophisticated institutional investors their joint liability will not exceed 50 percent of their proportionate liability. Small investors with less than $200,000 in net worth who have lost $20,000 or more will be fully compensated even in the frivolous type of case described above. Some wealthy Senators may think that this $200,000 net worth limit will not protect the average American; we inform those Senators that it is more than 4 times greater than the median net worth ($47,500) of American families.

The Shelby amendment, in contrast, would take us back to square one. Lawyers would still have every incentive to name as many wealthy companies as codefendants as possible, no matter how peripheral and tenuous their involvement, because ultimately, in every securities suit, every defendant could still be held liable for 100 percent of a judgment. Knowing that they could still be bankrupted by being held totally responsible for paying a frivolous, enormous claim, companies would still settle out of court. The Shelby amendment gnaws at the edges of the problem, but its solution is so weak as to be meaningless. Therefore, we urge its rejection in favor of the true reform offered by the bill substitute amendment.